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In The

Supreme Court of the United States

LANCO, INC.,

Petitioner,

v.

TAX COMMISSIONER OF THE STATE OF NEW JERSEY,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of New Jersey

BRIEF OF *AMICUS CURIAE* THE SHERWIN-WILLIAMS COMPANY IN SUPPORT OF PETITIONER

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STATEMENT OF INTEREST OF *AMICUS CURIAE*[1]

The Sherwin-Williams Company ("Sherwin-Williams") is an Ohio Corporation in the business of manufacturing and retailing paint and paint-related products. Sherwin-Williams is actively engaged in interstate commerce, doing business in all 50 states. As such, Sherwin-Williams relies on this Court's interpretation of the Commerce Clause of the United States Constitution when making business decisions and otherwise conducting itself in the interstate marketplace.

As this Court noted in *Quill Corp. v. North Dakota*, the law in the area of state tax nexus is in something of a quagmire. 504 U.S. 298, 315 (1992). This is especially true in the context of state income tax nexus. Fifteen years ago in *Quill*, this Court reaffirmed the long-standing rule that a business must be physically present before a state may impose the burden to collect its sales tax on that business. *Id.* at 317-18. Businesses relied on *Quill* and the fact that this Court has never held that a state may impose its tax on a business without physical presence. Businesses reasonably believed the physical presence rule applied to all types of state tax and made decisions consistent with this reasonable understanding. Some state courts and state departments of taxation agreed,[2] while other states

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[1] The parties have consented to the filing of this brief.

Counsel for a party did not author this brief in whole or in part. No person or entity, other than the *Amicus Curiae*, its members, or its counsel made a monetary contribution to the preparation and submission of this brief.

[2] For instance, in 2000, the Tennessee Supreme Court affirmed a lower court decision holding the physical presence rule applies in the context of the income tax. *JC Penney Nat'l Bank v. Johnson*, Comm'r of Revenue, No. M1998-00497-SC-R11_CV (Tenn. May 8, 2000) (per

(Continued on following page)

saw an opening to increase revenue based on this Court's dicta in *Quill*.

Starting with South Carolina, many state courts, leaping a few logical steps, adopted the theory that *Quill* applies only in the context of the sales tax. *See Geoffrey, Inc. v. SC Tax Comm'n*, 437 S.E.2d 13 (S.C. 1993); *see also, e.g., A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. 2004); *Geoffrey, Inc. v. Oklahoma Tax Comm'n*, 132 P.3d 632 (Okla. Civ. App. 2005). These states, seizing upon dicta in *Quill*, concluded they could impose their income taxes on businesses with absolutely no physical presence within their borders.[3]

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curiam). The New Jersey Tax Court, in this case, similarly held that the physical presence rule applies in the context of the income tax only to be later reversed by the state's appellate court, whose decision was later affirmed by New Jersey's highest court. *Lanco, Inc. v. Director, Div'n of Tax'n*, 21 N.J. Tax 200 (2003).

[3] For example, the West Virginia Supreme Court of Appeals recently held:

> [T]he Supreme Court appears to have expressly limited *Quill's* scope to sales and use taxes. First, the *Quill* Court noted that "[although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule." *Quill*, 504 U.S. at 314, 112 S.Ct. at 1914. Also, the Court commented that "although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes." *Id.*, 504 U.S. at 317, 112 S.Ct. at 1916. We believe that a reasonable construction of this language clearly implies that *Quill* applies only to sales and use taxes and not to other types of state taxes.

(Continued on following page)

Businesses like Sherwin-Williams relied on *Quill* and its ancestors in the absence of a separate ruling from this Court on state income tax nexus. When states impose their income tax on corporations with no physical presence, the consequences are often extremely and inappropriately harsh. This climate of uncertainty and potential harshness prevents multistate businesses like Sherwin-Williams from confidently broadening the scope of their interstate activities. Therefore, not only is it in Sherwin-Williams' interest, but also the free flow of interstate commerce necessitates this Court clarify that the bright-line physical presence rule applies in the context of the state income tax.

SUMMARY OF ARGUMENT

In *Quill*, this Court held that the bright-line physical presence rule furthered the ends of the Commerce Clause, declaring "[u]ndue burdens on interstate commerce may be avoided . . . in some situations, by the demarcation of a discrete realm of commercial activity that is free from interstate taxation." 504 U.S. at 314-15. This Court further explained that a bright-line physical presence rule establishes the states' taxing authority and consequently reduces litigation related to that authority. *Id.* at 315.

This is exactly why a bright-line physical presence rule in the context of state income tax nexus is critical to a multistate businesses like Sherwin-Williams. There is no justification for a bright-line physical presence rule only in

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Tax Comm'r of State v. MBNA America Bank, N.A., 640 S.E.2d 226, 232 (W.Va. 2006).

the context of the sales or use tax. Despite what some state courts and academics claim, the reality from the perspective of multistate businesses is that the complexities and compliance demands of income tax laws require greater certainty and a clearer nexus rule than sales and use tax laws demands.

In addition, more is at stake for multistate businesses when a state directly imposes its income tax on those businesses versus when a state imposes on such businesses the mere duty to collect sales or use tax from customers for remittance to the state. The uncertainty resulting from the lack of a bright-line physical presence rule has created a harsh environment in which multistate companies are potentially subject to unjustifiably huge penalties and back income tax liabilities for periods extending back many years.

Moreover, dramatic changes in the climate of interstate commerce occurring since the *Quill* decision in 1992 have raised the stakes even higher. Since *Quill* was decided, the nation has experienced several financial accounting scandals and a dramatic rise in attention to corporate financial accountability. Along with Congressional mandates like Sarbannes-Oxley, the Financial Accounting Standards Board ("FASB") has issued rules for corporate accounting increasing the stakes associated with accounting for income taxes on corporate financial statements. FASB Statement No. 109, *Accounting for Income Taxes* and its related interpretation, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"), relate to the recognition of tax benefits and liabilities on a company's financial statement. FIN 48 magnifies the ill effects of the ambiguity surrounding the Commerce Clause as it applies to state income tax nexus.

As *Quill* explains, a bright-line physical presence rule allows corporate taxpayers to precisely determine whether a state may impose a tax on them and if so, to what extent the state may tax them. This principle does not only mandate a bright-line physical presence rule in the case of state sales and use tax. Because of the complexities of income tax laws, the burdens of compliance, and the high stakes involved, a bright-line physical presence rule is absolutely critical in the case of state income tax nexus.

ARGUMENT

I. The Burdens of Compliance with and the Complexity of State Income Tax Laws Necessitate a Bright-Line Physical Presence Rule for State Income Tax Nexus.

While the New Jersey court in this case maintains that there are "'important distinctions between sales and use taxes [as compared to] income and franchise taxes that makes the physical presence test . . . inappropriate as a nexus test' for taxation beyond the use and sales taxes," in fact, the opposite is true. *See Lanco, Inc. v. Director, Div. of Tax'n*, 879 A.2d 1234, 1240 (N.J. Super. A.D., 2005) (quoting *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 194) (alterations in original). Differences between the burdens of complying with sales tax laws versus the burdens of complying with income tax laws do not warrant a bright-line physical presence rule for one and not the other. If anything, the compliance burdens associated with state income tax laws, financial accounting rules, and investor reliance on companies' effective income tax rates reporting dictate that it is even more important to have a bright-line unambiguous physical presence rule in the case of the

income tax than it is to have such a rule in the context of the sales tax.

Sherwin-Williams is on the front lines of state tax law compliance, working every day and devoting an entire department of the company to compliance with both sales tax laws and income tax laws, as well as many other types of tax. Sherwin-Williams has first-hand knowledge that complying with state income tax laws is more burdensome than complying with any other type of tax law and income tax laws are far more complex than any other type of tax law, including sales and use tax laws.

Some State courts and academics have focused on the number of returns rather than the complexity of compliance with the respective state laws and generally grossly underestimate the amount of jurisdictions to which multi-state companies must file income tax returns. A typical state court justification for concluding that compliance with state income tax laws is less onerous than compliance with state sales tax laws is because "state income tax is usually paid only once a year, to one taxing jurisdiction and at one rate, [but] a sales and use tax can be due periodically to more than one taxing jurisdiction within a state and at varying rates." *A&F Trademark, Inc. v. Tolson*, 605 S.E.2d 187, 194 (N.C. App. 2004); *see also, e.g., Tax Comm'r v. MBNA America Bank, N.A.*, 640 S.E.2d 226, 234 (W.Va. 2006); Cory D. Olson, Comment, *Following the Giraffe's Lead – Lanco, Inc. v. Director, Division of Taxation Gets Lost in the Quagmire That Is State Taxation*, 6 MINN. J. L. SCI. & TECH. 789, 813-14 (2005).

This is not the reality for multi-state businesses like Sherwin-Williams. In many states, localities are permitted to impose their own income taxes on corporations.[4] Additionally, many income-taxing jurisdictions require multiple income tax filings each year, as well as estimated periodic.[5] Also, when a corporate taxpayer needs more time to file a return it generally must file an application for an extension. Sherwin-Williams files returns in approximately 170 state and local income tax jurisdictions on behalf of itself and its subsidiaries. As such, over the course of a typical year, the Sherwin-Williams' Tax Department files approximately 1700 income tax returns, estimated periodic payments, or applications for extensions to file returns.

Another typical argument that compliance with state sales tax laws is more onerous than compliance with state income tax laws is that the differences are less complex between state and local income tax laws across jurisdictions than the differences in sales tax laws across jurisdictions. *See, e.g.,* John A. Swain, *State Income Tax Jurisdiction: A Jurisdictional and Policy Perspective*, 45 WM. & MARY L. REV. 319, 368 (2003) (arguing "several key features of state corporate income taxes suggest that they are significantly less burdensome" to comply with than state sales tax laws). From Sherwin-Williams' perspective, this is simply not true.

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[4] Sherwin-Williams' home city of Cleveland, Ohio, for example, imposes an income tax on the company as do over 50 municipalities in the Greater Cleveland area alone. CLEVE. CITY INCOME TAX ORD. § 191.0101 (2004).

[5] Alabama and Idaho are just two of many examples of income-taxing jurisdictions requiring quarterly filing. ALA. ADMIN. CODE 810-3-82-.02 (2006); IDAHO CODE § 63-3036A (2001).

The difference between state sales tax laws generally is limited to exemptions, rates, and the timing and manner of reporting. On the other hand, not only do jurisdictions vary in their income tax rates and timing and manner of income tax reporting, there are also countless other differences adding to the complex web of state and local income tax laws. State and local laws differ, for example, in what items qualify as non-business income, as well as allowable deductions, credits and depreciation methods. The amount of time and resources spent researching and collecting data necessary to claim certain state or local deductions and credits alone can be staggering.[6]

Additionally, some states require combined reporting, a single return for all affiliated corporations, while others permit each corporation to file a separate return. Further complicating matters, some combined reporting states require all domestic and foreign affiliates file a single return, while others only require domestic affiliates file a single return. Also, each state has its own formula for calculating the amount of income allocable to it, known as an apportionment formula. Different states may use a different combination of three factors in their apportionment formulas: sales, payroll, and property. Some states

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[6] One employee in the Sherwin-Williams Tax Department estimates he spent 90 hours annually working to comply with the requirements for claiming the Ohio Refundable Jobs Credit, ORC. ANN. § 122.17 (2006). He spends this time coordinating with other departments within Sherwin-Williams, creating databases of information, sorting through documents, and researching changes to the required form and manner of submission of the information. According to this employee, he spends a similar amount of time working on compliance with the requirements of income tax credits for other states.

use all three, some states use two, and some one. States also differ in what items are includable in each factor.

As a result of this greater complexity, Sherwin-Williams' Corporate Tax Department devotes significantly more of its resources to state income tax law compliance versus compliance with state sales tax laws. Sherwin-Williams' Tax Department employs four accountants who devote their entire time on the job to sales tax law compliance. Comparatively, Sherwin-Williams' Tax Department employs seven accountants who devote their entire time on the job to income tax compliance.[7]

The only reason Sherwin-Williams needs four accountants for sales tax is the volume of returns, since sales tax returns are relatively uniform. Conversely, even though there are fewer returns to prepare, Sherwin-Williams needs seven income tax accountants to handle the complexity of income tax returns. Further illustrating the point, the Sherwin-Williams' income tax accountants are employed at a higher grade level than its sales tax accountants: Sherwin-Williams Tax Department spends 25% of its salary budget on income tax accountant salaries, while spending only 12.5% of its salary budget on sales tax accountant salaries.

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[7] The income tax accountants split their time between state and federal income taxes, spending the majority of time working on strictly state issues. It is worth noting that much of the work these accountants do related to federal income taxes is also applicable to state taxes in some way, as many states base at least some of their income tax laws on federal income tax laws. Nebraska, for example, follows the Internal Revenue Code's approach to interest deduction, although with minor modifications. NEB. REV. STAT. § 77-2716 (2007).

Besides accountants, the Sherwin-Williams Tax Department employs five attorneys who spend the vast majority of their time addressing state tax issues addressing income tax issues. The complexity of state income tax law might be best evidenced by the fact that the Sherwin-Williams Tax Department spends a whopping 94% of its state tax litigation budget on litigating income tax issues, while it allocates merely 6% on sales tax issues.

II. The Stakes Are Higher for Multistate Businesses When States Directly Impose Income Taxes on Them Than When States Impose the Duty to Collect Sales or Use Tax on Them, Necessitating a Bright-Line Physical Presence Rule for State Income Tax Nexus.

Besides the greater complexities of and burdens of compliance with state income tax laws, multistate businesses have more at stake when a state asserts nexus to impose a tax on the businesses own income than these businesses have at stake when a state imposes the duty to collect the sales and use tax from their customers. First, in many states, businesses are reimbursed a percentage of the sales tax collected from their customers as compensation for the burdens related to complying with sales tax laws. *See, e.g.,* FLA. STAT. § 212.12(1) (2007) (allowing businesses to retain a percentage of the sales or use tax it collects). Businesses must bear the cost of the burdens related to complying with income tax laws themselves.

Second, businesses bear the cost of the income tax out of their own capital, while merely remitting funds they collect from customers to pay the sales or use tax. Accordingly, a corporation's income tax expense is deducted from its overall earnings while amounts remitted as sales and

use taxes are not. This is of particular importance to multistate businesses like Sherwin-Williams, because shareholders and other investors generally gauge a corporation's health by how much that corporation earns per share.

Shareholders and investors are concerned about a corporation's state income tax expense because that corporation's effective tax rate, the amount of recognized tax expense related to the income earned in a given year,[5] effects its earnings per share: the more income taxes a corporation is expected to pay per dollar of earnings the lower the earnings per share. Thus, shareholders and investors benefit from a precisely calculated effective tax rate because such gives them confidence in their ability to gauge the health of that corporation.

Besides benefits related to investor confidence, corporations benefit from a precisely calculated effective tax rate because such allows a corporation to know more precisely how much capital it will have available for investment, dividends, pension contributions, and salaries, as well as how its shares are priced on the public market. Lenders rely on this information to determine the corporations debt-rating.

Third and most importantly, multistate businesses like Sherwin-Williams have long relied on *Quill* and its ancestors in the absence of a separate ruling for state income tax nexus. Before a state jumped on the economic nexus bandwagon, businesses without physical presence in that state had no reason to file an income tax return in

[5] The effective tax rate is calculated as the year's recognized tax expense divided by the year's profits before tax.

that state. This fact is of great consequence to these businesses because if a business does not file a return the statute of limitations does not begin to run in most jurisdictions. *See, e.g.,* ILCS Chapter 35 § 5/905(C) (2006); N.J. REV. STAT. § 54A:9-4(C)(1)(A) (2006).

As a result and despite these businesses' reasonable reliance on *Quill* and its ancestors, such businesses may be liable for unquantifiable back taxes and interest attributable to long ago tax years. Along with back taxes and interest, states will likely also assess penalties for failure to file a return and for failure to timely pay income taxes due. These penalties are generally calculated as a percentage of the state-claimed back tax liability. *See, e.g.,* HAW. REV. STAT. § 231-39 (2007) (imposing a penalty of as much as 25% of the balance due, for the late filing of a corporate income tax return); ME. REV. STAT. ANN. 36 § 187-B(1)(C) (imposing a penalty of as much as 100% of the assessed taxes for the late payment of corporate income taxes).

Thus, under the current climate of ambiguity, multistate businesses are unjustifiably threatened by constantly compounding tax, interest, and penalty liability. A bright-line physical presence rule would remove this threatened avalanche and would consequently facilitate the interstate growth of multistate businesses like Sherwin-Williams.

III. The Recent Dramatic Rise in Attention to Corporate Financial Accountability Necessitates a Bright-Line Physical Presence Rule for State Income Tax Nexus.

In today's business climate, more than any other time, a bright-line physical presence rule for income tax nexus is

critical to the free flow of interstate commerce. Now, more than ever, multistate businesses must have the ability to determine their income tax expense as precisely as possible. To address recent financial reporting scandals and to better ensure that corporate financial statements are worthy of investors' reliance,[9] Congress, the SEC, and FASB have increased their regulation and scrutiny of financial reporting. A bright-line physical presence rule would further the aims of Congress, the SEC, and FASB in the area of financial accountability by facilitating a more precise determination of multistate corporations' state income tax expenses and effective tax rates, while the current uncertainty surrounding state income tax nexus thwarts their aims.

Of particular relevance is a recent FASB pronouncement, FIN 48. By way of background, FASB is charged with promulgating corporate accounting rules that are binding on businesses like Sherwin-Williams. One such rule is FASB Statement No. 109 *Accounting for Income Taxes* ("FAS 109"). FAS 109 provides guidelines for reporting the estimated amount of income taxes payable or refundable in a current tax year. In 2006, FASB clarified FAS 109 by issuing FIN 48 to address problems related to accounting for contingent income tax benefits.

FIN 48 limits the income tax benefits a corporation can recognize on its financial statement to those arising from tax positions "more likely than not" to ultimately be sustained. For purposes of FIN 48, an income tax position

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[9] Shareholders and other investors rely on a corporation's financial information including its reported income tax expense and effective tax rate to measure the health of that corporation.

is more likely than not to be sustained if it has a greater than 50% likelihood of being sustained on audit. The more-likely-than-not standard simply determines whether the benefit may be reported on the financial statement at all. If the benefit does not meet the more-likely-than-not threshold the company may not recognize a single dollar of the benefit on its financial statement.

If the benefit meets the more-likely-than-not standard, the company still will likely not be able to report the entire benefit on its financial report. Instead, the company may only include the portion of that benefit that is more likely than not to be sustained on audit. The company determines the reportable portion through the use of a complicated probability analysis and must make detailed disclosures of its analysis. In most cases, the end result is that companies will be able to report only a fraction of the tax benefits they expect during the tax year.

FIN 48 also requires that a corporation report potential penalties related to its tax positions as a tax liability, off-setting the benefit of that position, unless the corporation meets the statutory requirement for waiver of that penalty. In the context of state tax, this sometimes means that all potential penalties must be included on the financial statement as a liability because there is no statutory provision for waiver of that penalty.[10] This is particularly onerous because under current conditions, as discussed

[10] In Alaska, for example, penalties may only be waived in the discretion of the Department of Revenue or the Attorney General. ALASKA STAT. § 43.05.070 (2006). Therefore, there is no statutory provision for waiver of the penalty and a company must account for all potential Alaska penalties on its financial report.

above, states may potentially impose enormous penalties on corporations with no physical presence within the state.

For these reasons, the ambiguity surrounding the issue of state income tax nexus interferes with corporations' abilities to conduct themselves in the interstate marketplace. The more uncertainty surrounding an income tax position, the less likely it is that a corporation may recognize the benefit from such a position on its financial statement under FIN 48. As a result, the financial statement may reflect lower earnings per share than reality dictates. Combined with the fact that FIN 48 also requires that corporations reserve for potentially enormous penalties resulting from this uncertainty, until the law in this area is clear, corporations will also likely have less available capital for investment. Finally, the potential liability for failure to file and substantial underpayment penalties, alone, is enough for businesses to think twice before expanding operations interstate.

A clearly articulated physical presence rule for state income tax nexus would go a long way to furthering the ends of FIN 48. Such a rule would reduce uncertainty related to multistate businesses' state income tax positions resulting in a more realistic report of multistate corporations' income tax expense, effective tax rate, and earnings per share.

CONCLUSION

For these reasons, The Sherwin-Williams Company respectfully requests that this Court grant Lanco's petition for a writ of certiorari and reverse the decision of the Supreme Court of New Jersey.

Respectfully submitted,

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